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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1946.

No. 268

O. WILLIAM LOWRY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

REPLY BRIEF

MAY IT PLEASE THE COURT:

I.

The Tax Court's findings of fact relied on by the respondent are immaterial or are not supported by any evidence.

In answer to our argument that the findings of fact by the Tax Court were not sufficient to support its judgment, Respondent contends, citing (p. 7) cases ante-dating *Dobson* v. *Commissioner of Internal Revenue,* 320 U.S. 489, that any statement of fact which can be spelled out of

the Tax Court's opinion may be used to support its decision, notwithstanding the Tax Court's failure to make a specific finding of fact on the question in issue.

In the *Dobson* case, this Court said (p. 502):

> "In view of the division of functions between the Tax Court and reviewing courts it is of course the duty of the Tax Court to distinguish with clarity between what it finds as fact and what conclusion it reaches on the law."

This "distinction" certainly cannot be made by the Tax Court "with clarity" if when professing to make findings of fact, labelled as such, that court omits a finding of fact on the most important factual question before it—as it did here.

It is true that under Section 1117 of the Internal Revenue Code the Tax Court may "include in its report upon any proceedings its findings of fact *or* opinion *or* memorandum opinion" and that these alternatives permit the Tax Court to dispense with formal findings of fact if it wishes. But in the present case the Tax Court did not dispense with findings of fact; it undertook to make specific findings. If such findings may not be looked to by a litigant to determine the facts by which the taxpayer is bound under the *Dobson* case, where must the taxpayer look? How, in the language of the *Dobson* case, may the Tax Court "distinguish with clarity between what it finds as fact and what conclusion it reaches on the law" unless the Tax Court puts its factual findings where they belong, namely, in the findings of fact?

We submit that under the *Dobson* case, the Tax Court must when it professes to make findings of fact, make them complete enough to sustain its judgment. In no other way can the requirement of this Court laid down in the *Dobson* case be enforced.

We pointed out in our petition (p. 11) that the "findings of fact" of the Tax Court (R. 190) found that the petitioner's gift of stock to his wife, which stock she contributed to the capital of the partnership, was an ineffective transfer because the petitioner "did not relinquish dominion and control over any part *of the assets of the corporation* by reason of the gifts of stock in the corporation." We further pointed out that this finding of the Tax Court was immaterial because the question in the case was not whether the petitioner's wife acquired dominion over the assets of the corporation, but whether she acquired dominion *over the corporate stock* which was the subject of the gift.

The only comment of the Respondent on this argument is (p. 7):

"This finding was of itself sufficient to support the conclusion of the Tax Court that the wives were not conducting a business with their husbands as a partnership within the meaning of the Federal income tax statutes."

This bland statement is no answer to our argument. This sentence does not even refer to the status of the Petitioner's wife as a stockholder in the corporation, a status which she occupied for eighteen months before the partnership was formed, but ignores our arguments concerning *corporate* status and passes at once to the question of *partnership* status.

Hence, the Respondent has not answered our contention (Petition, p. 15) that the Tax Court confused the degree of control over corporate *assets* with the degree of control over shares of corporate *stock*.

Regardless of the inadequacy of the *findings of fact*, the Tax Court's judgment is unsound because the so-called finding of fact in the Tax Court's *opinion* (that the trans-

fer of stock in the corporation by petitioner to his wife was a step in the formation of the partnership) is not sustained by any evidence whatever. As already stated, the crux of this case was whether the Petitioner's wife had control of the *corporate shares* which were an outright gift to her eighteen months before the partnership was formed, and not whether she had control over the *corporate assets* during that period.

But the Respondent says (p. 7):

"The court below properly accepted as a finding of fact the statement in the Tax Court's opinion (R. 192, 195) to the effect that the gifts were made pursuant to a plan to dissolve the corporation and create a partnership with the wives as partners."

Assuming for the sake of argument that notwithstanding the instruction of this Court in the *Dobson* case it is permissible to require the taxpayer to search the opinion of the Tax Court for findings of fact, still the Respondent has not met the challenge on page 14 of our petition to point out any substantial evidence that the gift of stock from the Petitioner to his wife in May, 1937, had anything to do with the formation of the partnership eighteen months later.

In the *Dobson* case this Court said (p. 501):

> "Its [the Tax Court's] decision, of course, must have 'warrant in the record' and a reasonable basis in the law. But 'the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body.'"

There is not one iota of evidence in the record to support the so-called finding of fact in the Tax Court's opinion to the effect that the gift of corporate stock in May, 1937, had any relationship whatever to the partnership formed eighteen months after the gift. The failure

of the Respondent to point to such evidence in the face of the challenge made in our petition for certiorari (p. 14) is a confession that with respect to the present Petitioner there is no evidence that the gift of the corporate stock and the formation of the partnership were steps in a single plan. The Petitioner's situation has been confused with that of his fellow shareholder, Charles R. Sligh, whose gift of corporate stock to his wife was almost contemporaneous with the formation of the partnership.

We have shown that so far as the Petitioner Lowry is concerned the Tax Court erred first in holding that the gift of corporate stock by Petitioner to his wife failed because it did not carry with it control over the assets of the corporation, and second, in holding without evidence that the transfer of corporate stock by petitioner to his wife was made pursuant to a plan to dissolve the corporation and form a partnership.

We have fulfilled the burden imposed by the *Dobson* case which held (p. 502) that "when the court cannot separate the elements of a decision so as to identify the clear-cut mistake of law, the decision of the Tax Court must stand."

We repeat what we said in our concluding sentence of the petition (p. 17): "It is apparent that the basis of the Tax Court's decision was wrong and that the decision should fall with the disclosure of that error."

The error we rely on is a clear-cut error of law.

II.

If the *Tower* Case is authority for the decision of the Court below, that case should be re-examined and modified.

The Court below relied upon *Commissioner of Internal Revenue* v. *Tower,* 328 U.S. .., No. 317, decided by this Court February 25, 1946, as authority for its decision, although it recognized that there were differences between the factual situation in the *Tower* case and in this one with respect to the Petitioner Lowry. Notwithstanding these differences, it affirmed the Tax Court in the case of Lowry as well as in the case of Sligh.

Not only are there difference of fact between the *Tower* case and this case, but a proper application of the language of the *Tower* case would indicate that the Petitioner Lowry's situation is not one which is governed by the *Tower* case.

In that case, Tower gave his wife shares of stock in a corporation on condition that they be contributed to the partnership thereafter formed. Three days later, the wife in the meantime having received no dividends, the corporation was liquidated and the assets were turned over to the partnership. The Tax Court held that the parties did not intend to carry on business as a partnership. This Court said:

"This finding, *since supported by evidence,* is final."

In the present case, the gift of corporate stock was outright. The transfer was not conditional upon the petitioner's wife contributing her share in the corporation to a partnership. Furthermore, no partnership was formed until eighteen months after the gift had become final and during which time dividends upon the wife's shares of corporate stock had been paid to her. When

the partnership was formed there is no suggestion that anyone but petitioner's wife was entitled, as of right, to the corporate assets which her corporate stock entitled her to receive on liquidation and which she contributed to the partnership.

For eighteen months, Petitioner's wife had had control and possession of her shares of corporate stock. It was hers, without earmarks. It was her property under the laws of the state of Michigan. Her husband could no more take it away from her than he could deprive her of property purchased by her or property earned by her or property inherited by her. It was hers. Being hers, when she contributed it to the partnership, she was entitled to such share in the partnership income as the contribution brought her under the terms of the partnership agreement. To hold otherwise in the case of a business where, as here, capital is just as important a factor as services in the production of income, is to say that income taxes in one year are to be based on the history of the property out of which such income arises.

In the *Tower* case this Court held that the findings by the Tax Court led to the inference that the husband still "controls" the income from the partnership, and stated definitely:

> "It is the command of the taxpayer over the income which is the concern of the tax laws—*Harrison* v. *Schaffner*, 312 U.S. 579."

There is no finding in the present case that Petitioner's wife lacked control over the income from the corporate stock, but, instead, the Tax Court went off on a tangent in asking and answering this question (Rec. 195):

> "Did petitioners divest themselves of ownership in one-quarter, each, *of the assets of the corporate business,* putting complete ownership of *property,* or

> of undivided interests in *property,* in their respective wives, so that they, in turn, were in a position to contribute capital to the partnership?" (Italics ours).

The Tax Court's negative answer to this question is based upon its refusal to recognize the existence of the corporation as insulating its shareholders from personal ownership of corporate assets. Under the *Tower* case, the question of "control" does not refer to control of corporate assets, but refers to "command over income."

In determining whether Petitioner's wife made a contribution of capital, the Tax Court omitted to find whether the Petitioner made a *bona fide* gift of corporate stock to his wife, but relied upon the immaterial finding (Rec. 196) that Petitioner did not relinquish dominion and control over *the interests in property* which he purported to give his wife *by way of transfers of stock in the corporation.* Petitioner did not purport to give his wife dominion over corporate assets; he did actually give his wife dominion over shares of corporate stock. There is no evidence or finding to the contrary.

Nor does the Tax Court make any finding supported by evidence that Petitioner had "control" of his wife's share of the partnership profits, except (Rec. 195) that the general partners (Sligh and Lowry) could decide when the partnership profits should be distributed, and that the limited partners had no such right. This is not a finding that the Petitioner had "command" of the income in the sense in which the word is used in the *Tower* case. An owner of A. T. & T. stock is taxable on income received on his stock even though the Board of Directors, and not he, has the sole power to determine when dividends shall be declared and paid. On the all-important question of "control" of the Petitioner over income from the partnership, the Tax Court's opinion

and findings are not definite or specific and to the extent that by a narrow inference they do support the Tax Court's decision, they are based on a clear-cut error of law—a confusion between control of corporate property, as such, and ownership of corporate stock which has a well-defined dissimilarity in law from ownership of the corporate assets.

If the test of "control" or "command" of income to which the *Tower* opinion gives at least verbal approval be applied, no great injustice is done. If the present case had been decided by a determination of the question whether in fact the Petitioner had control under Michigan law over the partnership income allocated to his wife and then taxed by the Respondent to the Petitioner, no complaint could be made. But this all-important question was not determined except in the immaterial holding mentioned above that the *time* of distributing partnership profits was a determination lodged with the general partners and not in the limited partners.

The decision in the *Tower* case that the income tax collector need not recognize as valid a partnership recognized as valid by state law has now given rise to cases holding that partnerships not recognized by state law may be recognized for Federal tax purposes—*Willis B. Anderson,* 6 T.C. ..., No. 133, May 6, 1946, CCH Decision 15,133; *Francis A. Parker,* 6 T.C. ..., No. 125, May 7, 1946, CCH Decision 15,135.

The decision in the *Tower* case has also led to dispute as to what a capital contribution "originating" with the wife is. Are prior *bona fide* gifts to her from her husband not to be recognized as her property, although (as here) she has paid tax previously on income from such property? Is a gift to be forever earmarked?

In *Harry Shulak,* CCH Decision 15,151 (M), April 30,

1946, Docket 6654, the Tax Court held that money given to a wife three years before constituted a capital contribution originating with the wife.

In *Mauldin* v. *Commissioner of Internal Revenue*, 155 F. 2d 666 (4th Cir., May 16, 1946) a wife's partnership interest acquired by gift in 1936 and taxed to her in 1937, 1938 and 1939, was held insufficient as a contribution to partnership capital of a new partnership in 1940. One of the three judges, (Timmerman, D. J.) dissented sharply, stating in part (p. 672):

> "By the phrase 'capital originating with her', the Court undoubtedly meant money or other asset which the wife owned in her own right, regardless of how she may have acquired it. It would be unreasonable to interpret the quoted words as meaning that a wife could not invest money or property which she lawfully acquired by way of gift, inheritance or otherwise in a partnership with her husband or with her husband and another. Simply because a woman is married is no reason for limiting the uses to which she may put her property. In common with all others, she is entitled to the equal protection of the law. We cannot read into the Supreme Court opinion a meaning of antagonism to married women."

It is true that in the instant case the Tax Court did not place its decision on the claim that capital contributed by the Petitioner's wife did not "originate" with her; it held that she had had nothing to contribute because the prior transfer of corporate stock was ineffective. Nevertheless, the *Tower* case is an effective bar here unless the term "originate" is construed, as it should be, to include property actually belonging to the wife regardless of its previous history.

In the instant case, the Tax Court recognized that a capital contribution by Petitioner's wife made her a *bona fide* partner, but then proceeded to test the validity

of the contribution by determining whether the transfer of corporate stock to her had also conveyed corporate assets. Except on this wholly untenable legal theory, the Tax Court made no finding that the transfer of corporate stock was ineffective or conditional. If the misapplication of legal theory is beyond redress, then the decisions of the Tax Court are beyond judicial review contrary to the review provisions of the Internal Revenue Code.

The Circuit Court of Appeals applied the *Tower* case here in such a way as to highlight the discrimination which that case imposes upon two persons identically situated, based upon the *history* of the partnership property out of which income has come. Such a result from the *Tower* case is inevitable unless the words "originating with the wife" be modified. Thus, in *S. Kenneth Alexander*, 6 T.C. 804, April 26, 1946, CCH Decision 15,102, acquiesced in by the Commissioner, the Tax Court held that partnership income was taxable to the wife where she *bought* a one-fourth interest in the partnership from her husband's uncle, even though she contributed no services to the partnership.

In *Harry Shulak*, CCH Decision 15,151 (M), already mentioned, the Tax Court similarly held that the purchase of an outstanding partnership interest by a wife made her a true partner of her husband. This means that taxability of partnership income in a particular year depends not upon services rendered in that year, nor upon a partnership share owned in that year, but upon the *history of how the partnership interest was acquired.* This means that identical interests will be taxed to the wife in one case and to the husband in the other, not because of anything occurring in the taxable year, not because of any distinction under state law of the right to receive income, not because of anything then inherent

in the partnership situation, but solely because, historically, one partnership interest was acquired by gift and the other was acquired by purchase. This is an earmarking of property on a purely artificial basis. It belies the protest of this Court in the *Tower* case that "command" and "control" over income is the true tax test. It bases taxation on history and not on then existing facts.

Furthermore, the *Tower* decision has been used by the Tax Court as warrant for ignoring not only state law but also the agreement between the partners. Thus in *Claire L. Canfield,* 7 T.C. No. 18, CCH Decision 15,225, decided June 13, 1946, where the wife contributed $4,900 of necessary capital to the $17,443.49 capital of an automobile sales agency the Tax Court held, in complete disregard of the partnership agreement providing for an equal distribution of profits, that the wife was to be taxed on 20% of the income and the husband on 80%.

Once the actualities of the state laws governing partnerships are disregarded, there is no stopping point. Either the Court should declare that husband and wife cannot be partners in any venture in which capital is important, and thus frankly legislate on the subject, or it should modify the *Tower* decision so that the question of what is a contribution to capital and what is control over income is remitted to state law for determination.

A refusal to do this leads not only to a continuation of the anomalous results already appearing in the Tax Court decisions, but will lead to serious injustices. The rights of the Petitioner's wife are governed by Michigan law. If income actually payable to her by a *bona fide* contract based upon a valuable consideration is taxed to the petitioner, he will not have funds to pay such taxes without invading his own income and eventually

his own capital. Petitioner's wife is not a party to this proceeding and is not bound by this Court's determination. Under Michigan law, there can be no doubt that Petitioner's wife may force payment to herself of 25% of any partnership distribution. Since Respondent contends these distributions to Petitioner's wife are Petitioner's income, he will, of necessity, further contend that amounts distributed by the partnership to Petitioner's wife are gifts by Petitioner. Thus Petitioner, if Respondent's contentions be sustained, would be in the unhappy predicament of being assessed income taxes and gift taxes without ever having in his possession or being able to retain even a sufficient amount of the subject matter to defray the tax. And because of cumulative tax rates, the more successful the partnership business, the worse Petitioner's predicament becomes.

The Respondent has not suggested how Petitioner can ever recover from his wife tax paid by Petitioner on partnership profits belonging to her, and the Revenue Act contains no method of Petitioner's obtaining relief. If this Court refuses to recognize the actualities of state law, this Court will place burdens on those situated as the Petitioner is situated which they will not have the means to discharge. We submit that this calls for a reexamination of the *Tower* case upon which the Respondent now relies.

Respectfully submitted,

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September 3, 1946.